



ALTEXPLOIT 2017-11-07

## RAMPING THE MARKETS: BANKING ON PONZI FINANCE

ECONOFICTION BANKING, CAPITAL, DERIVATE, FINANCE, MINSKY, PONZI FINANCE

When funded pension schemes were first put forward at the beginning of the 1970s as a private sector alternative to state earnings-related pensions, the merchant (investment) banks and stockbroking firms that promoted them did not anticipate how successful they would become in that, by the following decades, pension schemes and allied forms of life assurance would come to own most of the stocks and shares quoted on the world's stock markets. When pension funds held a minority of stocks, the funds could altogether put money into stock markets by buying stocks, or withdraw it by selling, without significantly affecting prices or the liquidity of the market as a whole. Now that pension funds and allied life assurance and mutual funds constitute the majority of the market, it is not possible for them to withdraw funds altogether without causing a fall in prices, or even a stock market crash.

Because of their success, pension funds have become the newest and possibly the most catastrophic example of Ponzi finance. The term Ponzi finance was invented by the American economist Hyman P. Minsky as part of his analysis of financial market inflation. It describes a form of finance in which new liabilities are issued to finance existing liabilities. According to Minsky, financial crises are caused by the collapse of 'financial structures' whose failure is precipitated by their increasing 'financial fragility'. Financial structures are simply commitments to make payments in the future, against claims that result in incoming payments in the future. For Minsky, the characteristic feature of financial markets and financial speculation is that they afford opportunities for economic units to enter into future financial commitments, in the expectation of gain. In this respect, at least, they are similar to fixed capital investment. Success in securing gains persuades speculators to enter into further commitments, which become more 'fragile', i.e., more prone to collapse because future commitments become more speculative and less covered by assured financial inflows.

Minsky identifies three types of financial commitments, which are distinguished by the different degree of financial risk that they entail. In hedge finance, future commitments are exactly matched by cash inflows. A common example is the practice in banking of lending at variable or floating rates of interest. In this way, if a bank has to pay more interest to its depositors, it can recoup the increase by raising the interest rates that it charges to its borrowers (assuming that its depositors cannot withdraw their deposits before the term of the loan expires).

Speculative finance is characterized by certain commitments which have to be covered by cash inflows which may rise or fall, or uncertain commitments against a fixed cash inflow. If a bank lends money at a fixed rate of interest it is engaging in speculative finance, because it is running the risk that it may have to pay a higher rate of interest to depositors if interest rates rise. However, to set against this risk it has the possibility that the interest rates paid to depositors may fall, and it will thereby make additional gains from a wider margin between lending and borrowing rates.

Ponzi finance, in Minsky's view, is a situation in which both commitments and cash inflows are uncertain, so that there is a possibility of an even more enhanced profit if commitments fall and the cash inflow rises. Against this has to be set the possibility that commitments and the cash inflow will move together so that only a minimal profit will be secured, or that commitments will rise and the cash inflow will fall, in which case a much more serious loss will be entered than would have occurred under speculative finance.

Ponzi finance lies behind the view that is no less erroneous for being widely repeated, that a higher return reflects the 'greater risk' of an enterprise. This is exemplified in the practice of banks charging higher rates of interest for what they perceive as greater risks. Behind this view lies the Austrian tradition, from Böhm-Bawerk onwards, of regarding economic outcomes as analogous to the gains and lotteries obtainable from repeated routine games, such as the tossing of a dice. The certain pay-off (or 'certainty-equivalent') is held to be lower than some possible pay-off. The association of the greater payoff with its lower probability then leads to a presumption that the latter 'causes' the former. However, the profits of companies and financial institutions are not the proceeds of gaming, however much enterprise in an unstable market system may appear similar to gambling. In fact, these profits are the outcomes of financial flows that ebb and progress through the economy, propelled by actual expenditure and financing decisions. The systems of financial claims and liabilities arising from those decisions become more fragile, as first speculative and then Ponzi financing structures come to predominate, and larger gains and larger losses may then be made. But the possibility of extraordinary profits or losses in Ponzi financing structures in no way means that realization of such profits is caused or justified by the possibility of the losses. Ponzi finance arises out of objective contractual obligations. The 'greater risk', which is held to justify a higher cost of finance, may be entirely subjective or a cover for monopoly profits in finance.

The simplest example of Ponzi finance is borrowing money to pay interest on a loan. In this case, the financial liability is increased, with no reduction in the original loan. Pyramid bank deposit schemes were the schemes after which this phenomenon is named, and they are perhaps the most extreme example of such financial structures. In a pyramid deposit scheme, the financier might take, say, Rs. 100 from a depositor, and promise to double this money after a month if the depositor introduces two new depositors at the end of that month. The two new depositors get the same terms and when they pay in their Rs. 100 respectively, Rs. 100 goes to double the money of the first depositor, and the other Rs. 100 is the financier's profit. The two new depositors get their profit at the end of the next month from the new deposits paid in by the four new depositors that they introduce to the scheme, and so on. Initially, such schemes promise and deliver good profits. But their flaw lies in the fact that they require deposits to rise exponentially in order to pay the promised rewards to depositors. In the example that is described above, deposits have to double each month so that after one year, the scheme requires Rs. 409,600 in deposits just to keep solvent. After the thirteenth month, Rs. 819,200 would need to be deposited to keep up promised payments to depositors. Such schemes therefore usually collapse when they run out of gullible people to deposit their savings in them. While their life can be briefly extended by persuading depositors not to withdraw their profits, this cannot work for more than one or two payment periods, because such schemes are so dependent on increasing amounts of additional money being paid into them in each successive period.

Ponzi schemes are named after Charles Ponzi, an Italian immigrant who swindled Boston investors in 1919 and 1920 with a pyramid banking scheme. Minsky noted that Ponzi's scheme 'swept through the working classes and even affected "respectable" folk'. Because they prey on the poor and the ignorant, Ponzi schemes in banking are usually banned, although this does not prevent them from occurring in countries where it is difficult to regulate them. In Minsky's view, financial collapses occur because booms in financial markets result in sufficient profits for speculative and Ponzi finance to induce a shift from hedge finance to speculative and Ponzi finance.

Ponzi finance in securities markets is much more common than in banking. Indeed, it is arguable that such finance is essential for the liquidity of markets in long-term securities: if a security is bought, it may have an assured 'residual liquidity' if it is a bond in that, when it matures, the money will then be returned to the investor. If, however, the security is a share which is not repaid by the issuer except on liquidation of the company, then it has no assured residual liquidity. Its liquidity depends on some other investor wishing to buy it at a reasonable price. If the share is to be sold at a profit, then the condition for this to happen is that demand for it has risen since it was bought. In this respect, liquidity and capital gains in the markets for long-term securities depend on Ponzi finance.

Ponzi finance was present at the very inception of modern stock markets. The South Sea Company and the Mississippi Company, whose stocks featured in the first stock market collapse of 1720, both ended up issuing stocks to raise finance in order to buy stocks to keep the market in their stocks liquid and stable. In modern times, this is a common feature of merger and takeover activity in capital markets. Corporate takeovers are frequently financed by issuing securities. The proceeds of the new issue are

used to buy in the target company's stock 'at a premium', i.e., at a price that is greater than the pre-takeover market price. The money raised by issuing the new stocks is used to pay the higher return to the stock-holders of the company being taken over. In this case, issuing new stock is exactly equivalent to the pyramid banking practice of taking in new deposits in order to pay an enhanced return to older depositors, which is the premium on the target company's stock. The main difference between the two types of operation is that, during such takeover activity, the stock market as a whole functions as a pyramid banking scheme. However, precisely because it is the market as a whole which is operating in this Ponzi way, the pyramid nature of the venture is less obvious, and the gains are greater, because more and wealthier contributors are involved. Since this is an outcome of the normal functioning of the market, which may hitherto have been acting in a perfectly proper and respectable fashion, raising finance for industry and providing for widows and orphans, it is not possible to 'finger' the perpetrator of the pyramid scheme.

A more obviously controversial kind of Ponzi finance is the practice known as 'ramping' the market. A financier discreetly buys up a particular stock over a period of time, and then announces with great fanfare that he or she is buying in the stock. There are few markets in which emulatory competition is as strong as financial markets, where being conservative in practice and faddish in innovation are preconditions for a 'sound' reputation. The 'sounder' that reputation, the more likely it is other investors will imitate the buying strategy. Indeed, there is an element of compulsion about it, depending on the reputation of the investor. Those investors without reputation must follow for whatever reasons the investment direction signalled by investors with reputation, or else languish among lower-growth stocks. As the price of the stock rises due to the increased demand for it, such reputable financiers quietly sell out at a profit to their imitators, thereby confirming their reputation for financial 'soundness'. Obviously, the better the reputation of the financier, the greater the gain from such an operation. To support such a reputation and legitimize the profits from trading on it, financiers will obviously attribute the gains from this practice to their own financial acumen, rather than confessing to having ramped the market.

The almost instantaneous dissemination of relevant information on which modern financial markets pride themselves (and which many financial economists believe makes them near perfect), also facilitates this kind of market manipulation. In securities markets, the investors emulating the financier are the equivalent of the new depositors. They too may make money, if they too can persuade subsequent new investors to buy at higher prices. As with the pyramid banking case, ramping markets depends on increasing interest by additional investors. Because in practice it is indistinguishable from normal trading (unlike pyramid banking, which is rather more obvious), and because any losers usually have other wealth to fall back on, such practices are frowned upon in securities markets, but cannot be eliminated. However, in the case of pension funds, the eventual losers will be ordinary working people, who will only have a minimal state pension in the future to fall back on. This makes it all the more important to understand how a reputable system for financing pensions has become a Ponzi finance scheme which will in future collapse.

Taken from here

[<](#) [PREVIOUS](#) [NEXT](#) [→](#)

---

## META

[CONTACT](#)

[FORCE-INC/MILLE PLATEAUX](#)

[IMPRESSUM](#)

[DATENSCHUTZERKLÄRUNG](#)

## TAXONOMY

[CATEGORIES](#)

[TAGS](#)

[AUTHORS](#)

[ALL INPUT](#)

## SOCIAL

[FACEBOOK](#)

[INSTAGRAM](#)

[TWITTER](#)